Section-by-Section Summary of the September 13, 1983, Committee Print of the Stark-Moore Discussion Proposal

The provisions of the September 13, 1983, Committee print reflect the life insurance taxation proposals described in the July 14, 1983, press release and the August 2, 1983, spread sheet. This memorandum summarizes the statutory draft.

The draft bill contains two titles. Title I (pages 3-80) is a complete substitute for the life insurance company taxation provisions of present law. Title II (pages 80-101) provides new rules relating to the treatment of life insurance products which are in addition to those of present law. At a number of significant points, the draft leaves issues unresolved. These blanks reflect the Subcommittee's specific instructions that the staff prepare and present options on particular issues.

<u>New section 801 -- Tax Imposed</u> (page 4)

New section 801 would impose a company level tax on "life insurance company taxable income" at the generally applicable corporate rates. The alternative tax on capital gains could apply. The special life insurance company deduction and small company deduction (see new sec. 806) would not reduce the tax on capital gains. Thus, the special deductions result, in effect, in a lowering of tax rates on ordinary income.

<u>New section 803 -- Life Insurance Gross Income</u> (page 5)

New section 803 would provide rules which are similar to those contained in present law. Under this provision, premiums and decreases in the amount of a company's reserves would be included in a company's income.

<u>New section 804 -- Life Insurance Deductions</u> (page 7)

New section 804 would provide for three types of life insurance deductions from gross income:

1. general deductions (new sec. 805),

2. the special life insurance company deduction (new sec. 806(a)), and

3. the small life insurance company deduction (new sec. 806(b)).

<u>New section 805 -- General Deductions</u> (page 8)

The general deductions which would be allowed under new section 805(a) are:

(1) benefit payments,

(2) increases in reserves (see new sec. 807),

(3) policyholder dividends (see new secs. 808 and 809),

(4) the company's share of intercorporate dividends,

(5) losses (see new sec. 810),

(6) premiums paid for assumption reinsurance, and

(7) amounts paid under reinsured contracts to reimburse the payor of policyholder dividends.

These deductions are comparable to those allowed under present law section 809(d) except that the special deductions for nonparticipating and group life, and accident and health contracts are eliminated and several items peculiar to the three-phase system under the 1959 Act are deleted.

Certain modifications of the otherwise applicable deduction rules that are comparable to the modifications contained in present law section 809(e) are covered in new section 805(b). These rules would, <u>inter alia</u>, prevent double deductions.

<u>New section 806 -- Special Deductions</u> (page 12)

New section 806 would provide two special deductions for life insurance companies. A generally available deduction would reduce the effective rate of tax on ordinary income. In addition, in the case of a small company, a deduction of 60 percent of the first $1 million of life insurance related income would be allowed. (This deduction, which would apply before the general deduction, would phase out at $4 million of income. In addition, it would be available only to a company with less than $500 million in assets).

The base on which these deductions would be computed is the lesser of the company's life insurance company taxable income or that income computed without taking into account items attributable to noninsurance business activities. This rule would prevent the use of these special life insurance deductions to reduce the effective tax rate on noninsurance businesses. Similarly, where insurance income is already

sheltered from tax by noninsurance losses, the special deductions would not apply. To prevent a company from increasing its special deductions by placing more profitable businesses in one entity and business that may experience losses in another, the draft would provide for determination of the special deductions on the basis of a controlled group of life insurance companies.

<u>New section 807 -- Reserves</u> (page 16)

Companies could continue to take deductions for increases in reserves of the type for which deductions are allowed under present law. Unlike present law, the draft would directly specify the proper method for measuring the reserve. In particular, the applicable reserve on any contract would be the higher of the cash surrender value, or the reserve calculated using the method, interest rate, and mortality assumptions required under new section 807. The reserve deduction would be reduced by the policyholder's share of tax-exempt interest (see new sec. 815).

The permitted methods are the commissioners' reserve valuation method (CRVM) for life contracts, the commissioners' annuity reserve valuation method (CARVM) for annuity contracts, and a two-year full preliminary term for noncancellable accident and health contracts. The permitted interest rate is the highest permitted in 26 States (in the year of issue or the preceding year). The mortality assumptions required are the most recent mortality tables adopted by at least 26 States (subject to a three-year grace period during which a company could decide when to give effect to a new table.)

<u>New section 808 -- Policyholder Dividends</u> (page 26)

New section 808 would provide the general rules for the deduction of policyholder dividends. Under these rules policyholder dividends would be defined to include excess interest, premium adjustments, and experience-rated refunds (on other than group pension contracts). In addition, amounts which would otherwise qualify as policyholder dividends but which increase either the cash surrender value of the contract or other benefits payable under the contract, or reduce the premiums otherwise required to be paid, would be treated as paid to the policyholders as a dividend and returned to the company as a premium. Policyholder dividends would be deductible when paid or accrued unless the limitation on dividends of mutuals applies.

<u>New section 809 -- Limitation on Policyholder Dividends Deduction of Mutual Companies</u> (page 28)

New section 809 describes the limitation on the deduction of policyholder dividends by mutual life insurance

companies. Generally, the limitation is the amount by which a company's gain from operations as shown for State regulatory purposes (with modifications) exceeds the company's imputed return on equity. In no event would the limitation prevent deduction of less than a minimum percentage of policyholder dividends paid by a mutual company or permit deduction of more than a maximum percentage of such policyholder dividends.

Under the general limitation, the deduction for policyholder dividends would allow the deduction of the amount of dividends that would reduce the company's statutory gain from operations to a level comparable to that typically earned by stock companies on their equity. This comparable level would be determined by multiplying the mutual company's equity base by an imputed earnings rate. The equity base is the company's capital and surplus increased by nonadmitted financial assets, the difference between statutory and tax reserves, any mandatory securities valuation reserves, and one-half of the provision for policyholder dividends that are to be paid during the following year. The limitation would define the deduction of policyholder dividends for tax purposes. Under this system, a company could show a tax loss after deducting policyholder dividends.

The statement gain from operations is that shown on the regulatory reports to the States determined without regard to policyholder dividends as defined for tax purposes and Federal income taxes and adjusted to reflect tax reserves.

For purposes of the policyholder dividends deduction, a stock company that is at least 80 percent owned by one or more mutual life insurance companies [mutual entities] would be treated as a mutual life insurance company.

<u>New section 810 -- Operations Loss Deduction</u> (page 36)

New section 810 would adopt the operations loss rules of present law section 812.

<u>New section 811 -- Accounting Provisions</u> (page 39)

New section 811 would specifically provide that Federal tax accrual accounting rules are to have primacy over State statutory accounting rules. State rules would apply to the extent consistent with, or required by, Federal tax rules. The draft, therefore, reverses the holding of the Supreme Court in <u>Comm'r</u> v. <u>Standard Life and Accident Ins. Co.</u>, 433 U.S. 148 (1977).

The draft retains the present-law authority of the Treasury to make reallocations of income, etc., in reinsurance cases but adopts a broader definition of "related parties." It also retains the temporary rule that disregards

excess interest guaranteed beyond the taxable year in computing reserve deductions.

New section 812 -- Company's Share and Policyholders' Share (page 43)

The company's and policyholders' respective shares of tax-exempt interest and intercorporate dividends would be determined under new section 812. These shares are used to (1) reduce the company's reserve deduction by the policyholders' share of tax exempt interest and (2) to limit the deduction for dividends received to the company's share of the dividends.

New sections 813 and 814 -- Foreign Provisions (page 46)

New sections 813 and 814 generally follow sections 819 and 819A of present law for foreign life insurance companies doing business in the U.S. with modifications to reflect the single phase tax.

New section 816 -- Life Insurance Company Defined (page 56)

New section 816 generally would continue present law for the definition of a life insurance company. An insurance company (i.e., a company more than half of the business of which is the issuing of insurance or annuity contracts or reinsuring risks underwritten by other insurance companies) is defined as a life insurance company if its life insurance reserves or unearned premiums and unpaid losses on noncancellable life, accident or health policies not included in life insurance reserves comprise more than 50 percent of its total reserves. For purposes of the definition, the amount of any reserve would be that shown for State regulatory purposes.

New section 817 -- Treatment of Variable Contracts (page 61)

New section 817 would provide special rules for the company tax treatment of variable contracts, that is, contracts under which the policy benefits are adjusted to reflect the current investment return and current market value of a segregated asset fund. This provision would continue the present law tax treatment for variable annuities and would extend the same treatment to variable life insurance.

New section 818 -- Other Definitions and Special Rules (page 65)

New section 818 would contain several provisions that are a continuation of present law. It would contain: (1) a definition of pension plan contracts (present law); (2) special rules for treatment of capital gains and losses

(present law); (3) a new definition that insurance or annuity contracts include contracts supplementary thereto; and (4) a new special rule for consolidated returns that would provide that the net operating loss of nonlife insurance members of the affiliated group would be taken into account in determining tentative LICTI before applying the special life insurance company and small life insurance company deductions.

Bill section 111 -- Effective Date (page 79)

The life insurance company taxation amendments made by the draft would apply to taxable years beginning after December 31, 1983.

Bill sections 112, 113, 114 and 115 -- Transitional Rules (pages 79 and 80)

Section 112 of the draft would require the recomputation of reserves under the provisions of the bill. Provisions dealing with the treatment of the balance in policyholders surplus accounts will be supplied by later subcommittee decisions. In addition, a special transitional rule for mutual life insurance companies with large surplus-to-asset ratios is being considered and may be supplied. Other special rules are provided in section 115 of the draft.

Bill section 201 -- Life Insurance Contract Defined (page 80)

New section 7702, which would be added to the Code by section 201 of the draft, would provide a definition of the term "life insurance contract" for tax purposes. This definition would be based on the temporary guidelines contained in present law for determining whether death benefits paid with respect to certain flexible premium life insurance products qualify as life insurance death benefits exempt from tax. Under new section 7702, a life insurance contract would be any contract that is a life insurance contract under applicable law and meets a "cash value accumulation" test or, alternatively, satisfies certain premium and cash value requirements. Both the cash value accumulation test on one hand, and the guideline premium and cash value requirements on the other hand, are designed to limit the use of life insurance products primarily as tax-favored investment vehicles instead of protection against early death.

In general, under the cash value accumulation test, a contract would qualify if the cash value does not exceed the cash value that would result if the premiums required under the contract were the level annual amounts which would have to be paid over a period of at least 10 years to fund the future benefits under the contract. Under the-two part alternative test, a contract generally would qualify if: (1)

total premiums paid for a level death benefit, at any time, do not exceed the sum of the premiums paid under a 10-pay life contract, or the sum of the level premiums paid over the life of the contract, assuming that the contract matures no earlier than age 95; and (2) the face amount of the contract is at least 250 percent of the cash value of the contract for a policyholder of age 40 or less, phasing down four percent each year until the face amount of the contract is 110 percent of the cash value. New section 7702 would also include a number of "special rules" and definitions for application of the above tests.

If a contract which is a life insurance contract under applicable law fails to qualify as a life insurance contract for Federal income tax purposes under new section 7702, the "income on the contract" would be treated as ordinary income received or accrued by the policyholder. Under a contract that fails to qualify, only the excess of the face amount over the cash surrender value will be treated as tax-exempt death proceeds.

<u>Bill section 202 -- Treatment of Certain Annuity Contracts</u> (page 93)

Section 202 of the draft would amend the rules relating to annuity distributions by eliminating the 10-year aging exception to the 5-percent penalty for premature distributions under section 72(q) of present law. In addition, annuity contracts would be required to be annuitized not later than age 70-1/2. Likewise, to avoid the penalty on income distributions prior to age 59-1/2, a contract would have to provide for an annuity for at least 10 years.

<u>Bill section 203 -- Limitation on Interest Deduction on Life Insurance Loans</u> (page 96)

Section 203 of the draft would amend present law section 264 to provide that no tax deduction would be allowed for interest paid on loans from life insurance policies to the extent that, for any person, the average daily balance of life insurance loans exceeds $50,000. For these purposes, a life insurance loan would be any loan (i) incurred under or secured by a life insurance, endowment or annuity contract, or (2) incurred or continued to purchase or carry a life insurance, endowment or annuity contract. Special rules would be provided for persons filing joint Federal income tax returns, controlled groups of corporations and partnerships and S corporations.

<u>Bill section 204 -- Adjustment in the Amount of Investment in the Contract by Reason of Life Insurance Protection Provided under the Contract</u> (page 99)

Section 204 of the draft would provide that, for purposes of computing income on cancellation or surrender of a life insurance contract, the taxpayer's investment in the contract as of any date be reduced by the cost of life insurance protection provided under such contract before such date.

Bill section 205 -- Group-term Life Insurance Purchased for Employees (page 100)

Section 205 of the draft would extend the $50,000 income exclusion limitation for group-term life insurance to retired employees. In addition, the nondiscrimination rules of present law would be extended to retired employees, and key employees under discriminatory plans would not be allowed to use the uniform cost table for including the cost of their group-term insurance in income.